DOW THEORY LETTERS INC.

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P.O. Box 15428
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36 Letters per Year — $60.00 Annually

Registered with the Securities Exchange Commission

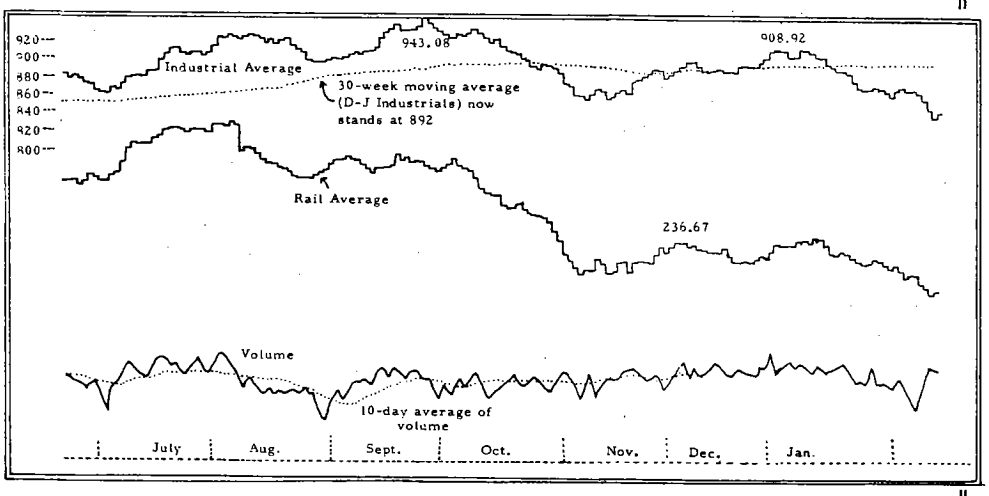
February 16, 1968 Letter 384

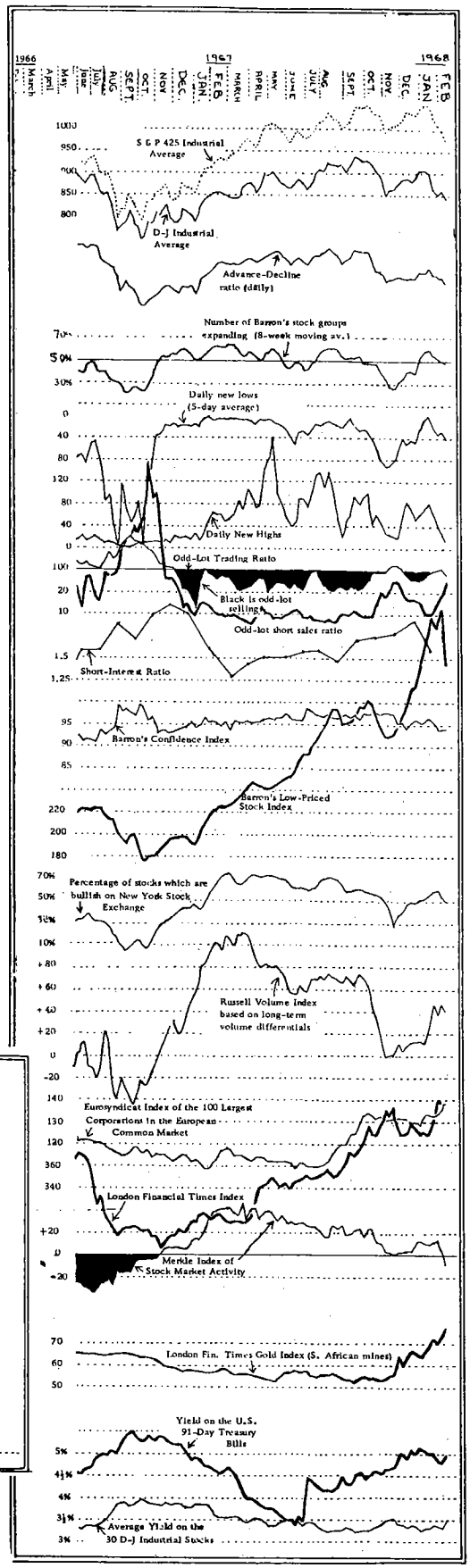
THE MARKET: According to Dow Theory, neither the duration nor the extent of a primary bear movement can be predicted in advance. Despite the almost frenzied efforts of the many investment services to "outguess" the market's action for the next few days and weeks, here is a thought which should be stamped into the minds of all subscribers. In recent weeks, 875, then 850, then 840, now 820 or 800 are termed "critical support levels" for the Dow. I well remember when the old 1929 high of 381 was called an impossible "resistance level" for the Dow on the upside. The fact is that resistance levels in primary moves are as deceptive as anything in the market can be.

Primary movements are a law unto themselves, and a study of past market history illustrates the extreme folly of attempting to peg "where the Dow will stop" or "where the next resistance point lies." According to my studies (discussed in detail in a later section of this Letter) we are now in the declining part of the second phase of this primary bear market. The end of the second phase should terminate at a new low for the bear market, the old low being the 1966 low of 744.32. I do not know how the Dow will make its way below 744.32, I do not know whether it will take a month, six months or a year, but this second phase should ultimately (and in its own time) take the Industrial Average to new bear market lows. Ours is not to reason why: it should be sufficient to depend on classical Dow Theory precepts. We should patiently allow the market to tell its own story.

I have not advocated trading in and out of this bear market as almost all of my investment advisory associates have seen fit to do. I believe that the great majority of people eventually sustain losses trading against the primary trend, and this fact is becoming increasingly obvious as the bear market progresses. Last week the advance-decline ratio broke to its lowest point since 1966, and this implies that on the average most portfolios built up during the hectic trading days of 1967 now sustain losses. These losses (if the stocks continue to be held) should increase before the end of 1968.

That is the reason I have advocated holding only Treasury bills and gold shares. Golds (which I have also stated should not be traded) are in a primary bull market of their own, and despite official denunciations, Governmental manipulations and widespread scepticism, the shares of the yellow metal continue (with intermittent reactions) to march to historic highs.




1966
1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily new lows (5-day average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicat Index of the 100 Largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Fin. Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

By all accounts the market is now supposed to be "oversold," and by most past standards the market is indeed oversold. The great "head-and-shoulders" top in the Dow was completed last week when the Dow broke the 849.57 level. The two Averages broke the important November, 1966 levels which I drew attention to in the last Letter, and as far as I am concerned the primary bear market (following the astounding 1966-67 secondary upward reaction) has been reconfirmed. We now know that all the action since the 1966 lows was part of a giant corrective movement. But the bear is now out of his lair again, and he is gathering strength.

This bear market has been unprecedented in many ways (so far), but I want readers to remember that sooner or later in almost every bear market there comes a great noise which we refer to as a crash. That noise has not yet sounded during this bear market (it was narrowly avoided in 1966), but the smash could lie ahead. As a rule, the longer the primary forces are manipulated or held back, the more powerful the action once the primary forces reassert themselves. The breaking of the November, 1966 lows on February 9 signalled the reconfirmation of the primary bear market, and I warn subscribers to avoid any preconceived notions (despite "crystal-gazing" market letters) as to what lies ahead.

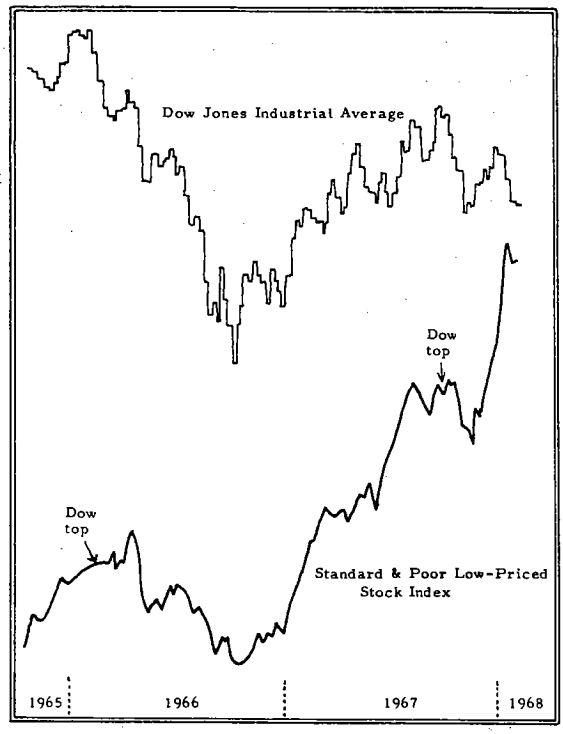
Perhaps the most important single concept in investing is to act with the power of the primary trend of the market. The primary trend cannot be circumvented, manipulated or legislated out of existence. It will express itself in its own way in its own time, and it will not terminate until the bull forces or the bear forces are exhausted.

Our job will be to identify the true third phase characteristics and final bottom of this bear market, and following are a few of those characteristics. Low, volume, squeezed-out margin accounts, dragging action in the Averages, absence of speculation, collapse of low-priced stocks, gloom on Wall Street and an almost universal feeling that "another bull market will never develop again." Frankly, I do not see one of these characteristics in today's market. But they will appear in time, and with them will develop the next fabulous buying and accumulation area. Fortunes will be made by those subscribers who possess the patience, self-control and fortitude to await (with their assets intact) the true third phase ending of this primary bear market.

* * * *

A few interesting items have appeared on our page 1 composite chart. The Merkle Index has sunk to minus 12, thereby going negative for the first time since early 1967. The Low-Priced Index has dropped violently to 356. The South African Gold Index has pushed to 76.5, thereby bettering its double tops of 1963-1965, and the Dow, the Standard & Poor 425 Index and the advance-decline ratio are all in gear on the downside. The 91-day Treasury bills have suddenly jumped back to the 5% yield area. All in all, a decidedly negative picture for the long term.

WIERD RELATIONSHIP: In past history it was normal for the "cats-and-dogs" or to be more polite the low-priced stocks to top out ahead of the final top on the D-J industrials. During early 1966 I repeatedly drew attention to the strange performance of the Dow and the low-priced stocks. Note on the accompanying chart that the Dow peaked in February, 1966, although the S & P Low-Priced Stock Index continued to new highs. It was not until late April that the L-P Stock Index finally turned down.



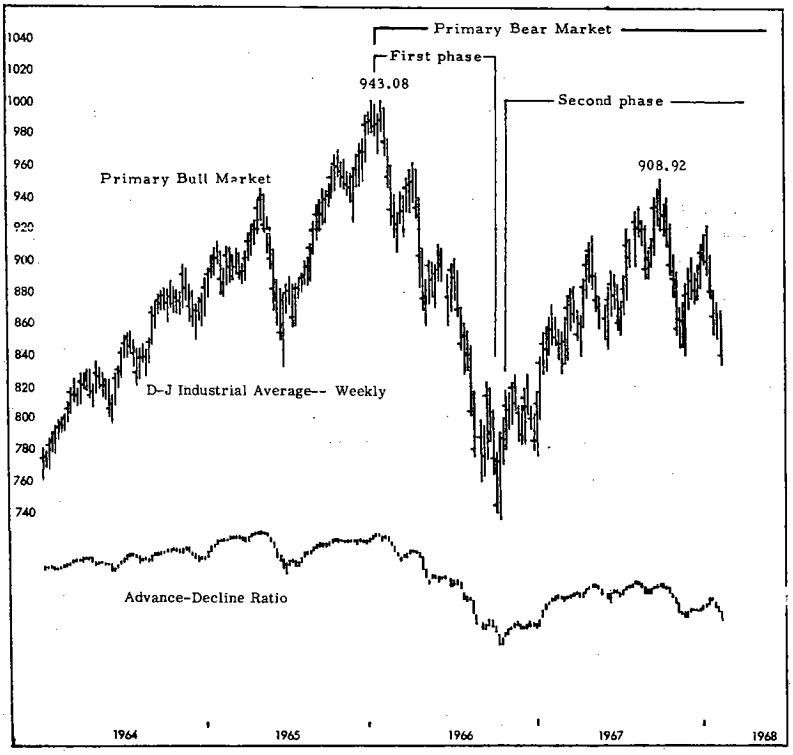
During that period I wrote that the relationship between the Dow and the L-P Index was most abnormal, that it implied informed distribution of investment-grade issues under a cover or camouflage of frenzied speculation in second or third grade issues. The final result was the 1966 cave-in, with all issues declining as the first stage of the bear market took hold.

The situation is now comparable but even more flagrant. Note that in 1966, following the final peak in the Dow, the L-P Index continued higher for another two months while gaining a final 12 points. But in 1967-68, following the September peak in the Dow, the L-P Index continued higher for an additional four months while gaining a final 43 points.

I consider the situation today to be generally even more dangerous than that which existed in early 1966. The relationship between the Dow and the L-P stocks is even more out-of-kilter now than in 1966, and speculation prior to the final peak in late-1967 was far more flagrant than that which existed prior to the 1966 top.

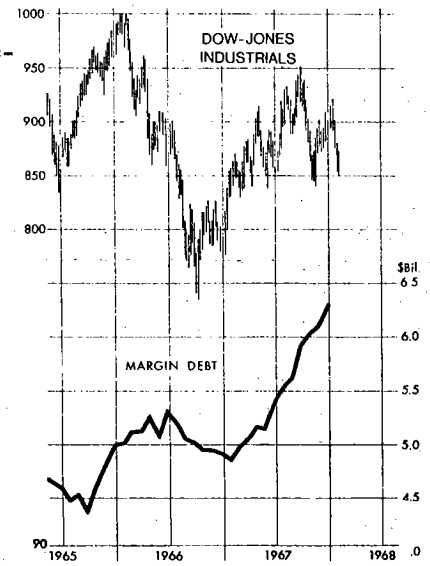
WHERE ARE WE: The track of the bear is always hard to follow. Bear markets, as I have often said, are meant to separate stock-holders from their money. The typical bear market is treacherous and deceptive. That is what keeps people in the market until it is "too late." Obviously, if the total bear picture was at once clear and obvious, every stockholder would sell at the same time. Then we would have a bear market that would last a day or so—and it would be over. But primary bear markets do not work that way. They tend to keep the optimists hoping. And let's face it, every stockholder is by definition an optimist with a vested interest. If he were not an optimist he would not be holding stocks.

As I see it (refer to chart—courtesy of Traders Research) the first phase of this bear market lasted from the 995.15 high on the Dow (Feb., 1966) to the 744.32 low (October, 1966). By definition the first phase erased the froth and floss of the preceding bull market's top. During 1966 many investment grade shares did get hit hard, and to all purposes the 1966 first phase was orthodox enough.



The second phase of the bear market began in October, 1966, and by my calculations is still on. But here we had an extraordinary rally, fed by massive doses of Government credit, mountains of official optimism, and a wishy-washy attitude regarding speculation on the part of the Federal Reserve Board. Business continued generally good, despite lower profits, and the public convinced itself that any potential trouble would be minor and transitory.

The second phase recovery topped out on Sept. 25, 1967, at 943.08 on the Dow. During the rally phase many stocks engaged in spectacular upward moves, while Wall Street swelled with new margin accounts and new margin credit (see chart, couresty of Holt Investment Service). "Beating inflation" was the name of the game, and "action" and "performance" was the way to do it. During the second phase rally, everyone and his brother took a flyer on his favorite tip or rumor, and the "junk stocks" went through the roof. Not so with the investment-grade Dow stocks. They recovered 63% of their 1966 losses, then settled back to trace out the massive "head-and-shoulders" top which is visible on every long-term chart. As seen on the Traders Research weekly chart, the advance-decline ratio too moved generally sideways, implying that the bulk of issues on the N.Y.S.E. had been marking time since early 1967.



The first phase of the bear market consumed exactly 8 months. Figuring that the second phase began in October, 1966, we have now been in the second phase 16 months so that already the second phase has lasted twice as long as the first phase. This is absolutely normal, and it would not surprise me to see the second phase continue through much of 1968, and even into 1969. The termination of the second phase should see the Industrial Average below the 744.32 low closing of 1966.

Following the termination of the second phase, regardless of the duration or extent of the coming decline, most people will expect another big recovery. Such a recovery may or may not come. Personally, I do expect a recovery, but because the recovery following the first phase was so speculative and extended, I am of the opinion that the next recovery will be sub-normal in extent and that it will not be accompanied by anything like the speculation seen during 1967.

The final or third phase of the bear market should come on low volume, amid great pessimism on the part of the public and most of Wall Street. Yet the third phase is the beginning of the accumulation phase as far as Dow Theorists are concerned, and just as this writer was one of the very few bulls on gold shares during the early 1960's (many have increased 500% since then), I expect to be one of the few bulls on the general stock market as we wallow and drag in the final third phase of the bear market.

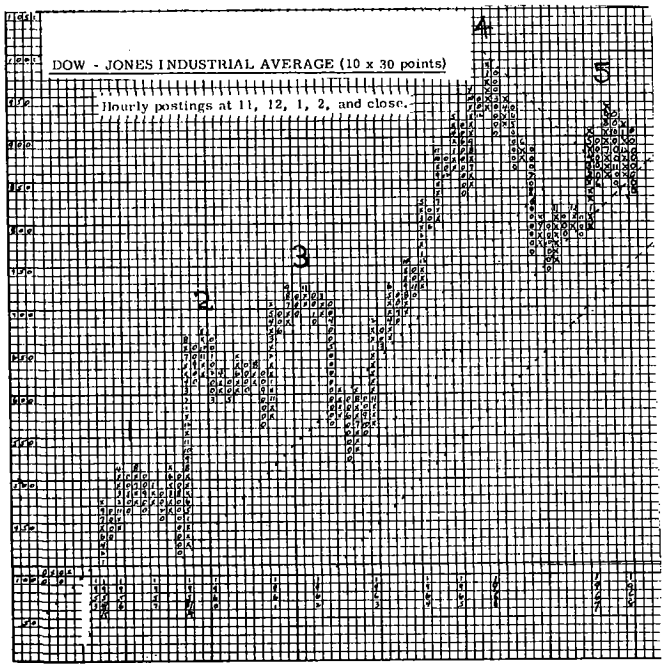
The reason why I am going into all this so repetitively and carefully is that I want my subscribers to prepare themselves for coming events, to "get their minds ready" for what may be arriving during the next few years. After all, if we expect a conclusion to the current second phase and a depressing and perhaps very frightening third phase, it will help us in our invest-

 ment attitude to be planning ahead for just such action. A man who has mentally gone through a battle is usually better prepared to handle himself than the man who is shocked and surprised by everything he sees.

I would rather my subscribers assume a patient but increasingly optimistic frame of mind as this bear market progresses. Every month that passes and every 10 points lower is a month nearer and 10 points nearer the final great accumulation area.

One of these times, during the several years ahead, my subscribers and I are going to be buying investment-grade issues at bargain prices— at a time when such action is going to be considered tantamount to madness. And just as we were buying President Brand gold mines at 9½ at a time when it was considered absurd to invest either in gold or South Africa (President is now 19 and has paid 8% to 10% dividends all along), we will be considered crazy to invest in common stocks at depressed prices when "everyone knows that they are going lower."

THE BIG TECHNICAL PICTURE: The accompanying chart (courtesy of my friends at Chartcraft, Larchmont N.Y.) offers massive perspective on what is happening. This is a 10 point, 30 point reversal point and figure chart. It shows all the important action in the D-J Industrials over the past 15 years.



Each individual square on this chart represents 10 points, and a new vertical row is added each time the Dow rallies or declines 30 points or more. That's why it is called a 10 point— 30 point reversal chart. In other words, the chart only shows the big reversals of 30 points or more. Rallies are shown on the chart by vertical rows of X's, declines by vertical rows of O's.

Note that I have designated five main distribution areas over the past 15 years. Distribution areas 1 through 4 were each accompanied by declines of varying intensities, and each was then followed by a fresh advance to new historic highs for the Industrial Average. In other words, after each of these distribution areas the primary bull market continued in force.

But as I point out in Letter 376, the latest area on the chart (marked 5) is the first one which formed below a preceding top. Note that following the 1966 top at point 4, there was a decline, and then a new rise. But the area 5 formed under 4, not above it as has been the case in all previous instances since 1953.

This is something new, and it is characteristic of a primary bear market. Secondly, it is interesting to see the massiveness and solidity of the top at point 5. The chart shows that the Dow traveled 60 points or more six times (six consecutive vertical rows of 60 points or more) during 1967-68. This is what formed this solid "block of distribution," and usually the more action within a distribution (or accumulation) area, the greater the ensuing move.

Finally, on this 10 point chart the Dow gave its bear signal at 840. This is at variance with the more sensitive 5 point chart shown in Letter 382, and at that time I stated that the first bear signal on point and figure was given when the Dow touched 880. I consider the 840 bear signal on the 10 point chart to be more important, more massive, and to imply that all the action since January, 1967, was in the nature of distribution. With the cracking of the 840 level, hundreds of millions of shares of stocks are locked in at higher prices and the decline portion of the second phase of the bear market is on in earnest.

NOTES AND QUOTES: After losing (and shipping out of the country) $900 million in gold during December, the U.S. announced another $100 millionloss in gold during the week ending January 9, 1968. This takes us down to the lowest gold level ($11.8 billion) since April, 1937.

* * * *

Some African nations (not just former French colonies) have been buying gold. So have Middle East countries and Shiekdoms. Big worry is that rich Kuwait will dump its sterling reserves, and a rumor has it that representatives of Kuwait have been in Paris talking about placing massive deposits. Any switch in Kuwait's huge sterling holdings out of Britain could cause serious trouble for the pound. Perhaps the most interesting rumor is that the Vatican purchased 15 tons of gold in Beirut in January (this from theChristian Science Monitor, Feb. 6). The Vatican has an enormous income from worldwide investments and contributions. Finally, Communist China has also been purchasing gold and shipping it to Peiping. China's largest source of hard currency is from its sales of opium and heroin.

* * * *

If the U.S. continues to lose gold, it could embargo or go off the gold-exchange standard. One bet if that occurs is that the gold-respecting European nations would then form their own gold bloc. Russia and the other Communist countries would probably attach themselves to the gold bloc, since they are extremely conservative in their gold policies. The dollar bloc would then probably consist of the U.S., Britain, Canada, Latin America, Japan, Australia and New Zealand.

 If such a situation develops, the dislocations in international finance and trade would be monumental. Trade between Europe and the dollar bloc nations would practically cease.

Quote below from U.S. News and World Report, Feb. 19:

A comment along similar lines comes from Europe: "American officials think gold is a Stone Age relic and that the dollar is the thing that the world really wants. Actually, nobody wants gold—except the French, Germans, Dutch, Italians, Belgians, Japanese, Chinese, Russians, Israelis, Arabs and, of course, everybody else."

Enter Politics: Devaluation—raising the price of gold—is nothing new in the world.

It's been the classical way to adjust for the monetary and fiscal errors of the past...like an individual going into bankruptcy, wiping the slate clean.

It's been the way to pay for past inflations...and to lay the groundwork for later new ones.

In the present instance it could be handled in a nice quiet way.

The International Monetary Fund could call a meeting of its more than 100 member nations.

The U. S. would then raise the price of gold—say 100% or more—and all other countries would revalue their currencies in terms of the dollar...some a bit higher, some a bit lower.

When this was all completed, every country would have more reserves and the capacity to expand their money supplies all over again.

Below from latest Babson Reports:

But the politicians in the U. S. don't like this idea.

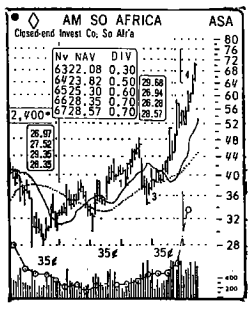
They say it would—like the "gentle rain from Heaven"—fall also on Russia and on South Africa...two big gold miners that have more enemies than friends in the United States.

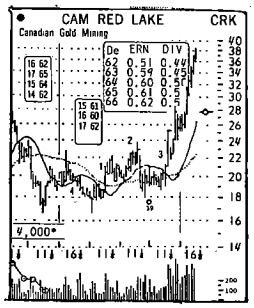
More important, it would be a boon to Charles the Great, ruler of France, who has avidly hoarded gold...waiting for the day when he could reap the reward of a price boost.

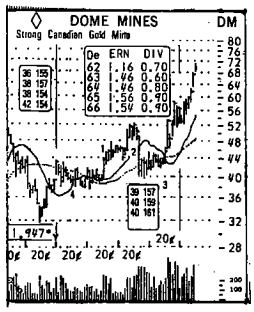
And there are also those who've trumpeted in and out of the halls of Congress that the dollar would never be devalued.

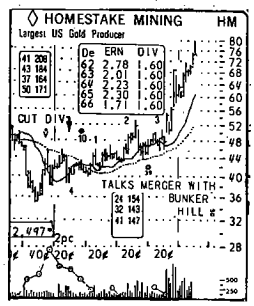
Such men will fight to the last inch to avoid such a move, unaware that the fiscal policies they've voted for have already devalued the dollar in all but name.

DOW THEORY MARKET LABORATORY PAGE





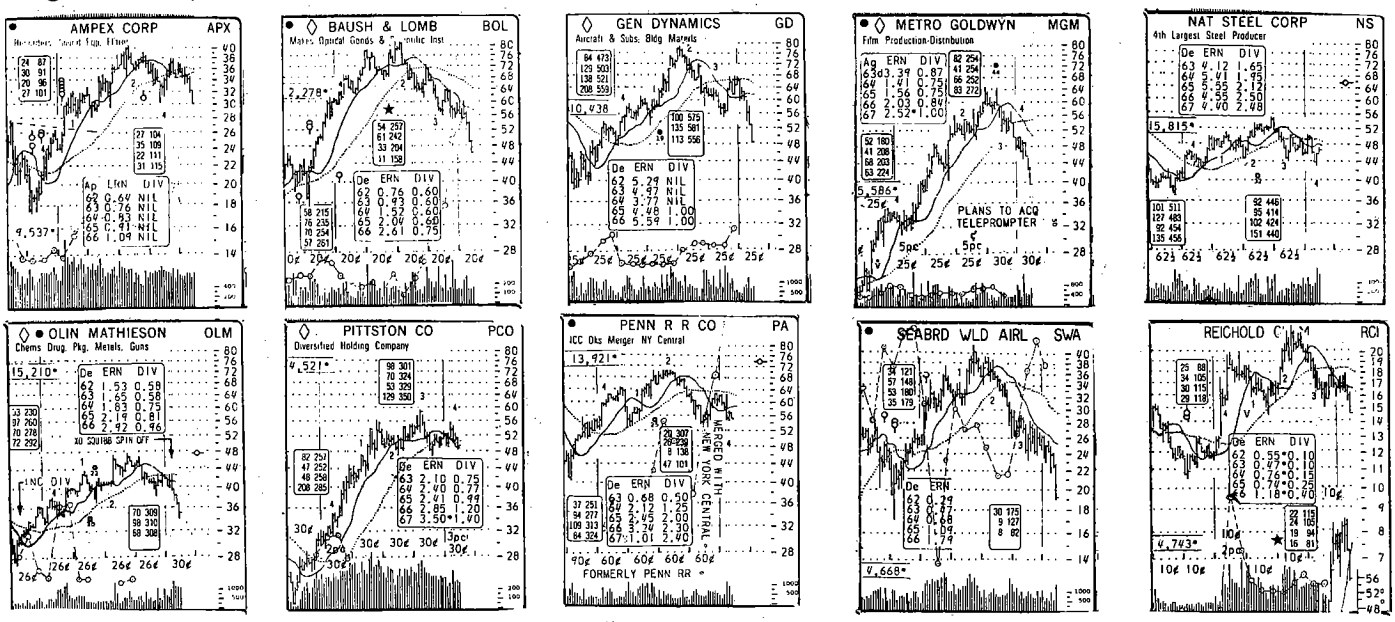




In the last Letter I reviewed some of the South African gold shares. Most of these have since run up to historic highs with Western Deep Levels now at 17½ and President at 19½. At these prices, they are roughly double the price at which I first recommended them a few years ago.

I show above (courtesy of Quote Digest, 110 Lorraine, Wichita, Kansas) weekly charts of the four listed N.Y.S.E. golds, all of which I have recommended over and over again. These stocks (I have drawn in the latest prices with my own pen) are now in the "blowin' in the wind" phase, with Homestake and Dome having jumped over 5 points each on Feb. 13. As stated before, the golds are in a primary bull move, and I don't have any idea where they are going (nor does anyone else). Speculators may now be coming into the golds ("what else can you buy in a bear market?"), funds may be buying them, the public could be nibbling at these thin issues. Whatever the case may be, they are rocketing now, and if you don't already own them I have not the slightest idea whether they are too high or not. It appears obvious that the golds are discounting a dollar devaluation or a world revaluation of gold. From every hand we are told not to buy them, or if you must buy them, "buy them on a correction." So far, they have not corrected, although I must admit they appear "ready for a correction." I have not taken profits in my own gold shares, and I'll probably sweat them out until something tangible happens on the monetary front.

Meanwhile, on February 13 the market smashed through the highly touted 840 (Dow) level, and I spent half a day studying charts of Big Board stocks. I was looking for the tell-tale signs of a major top, and that means the classic "head-and-shoulders" formations



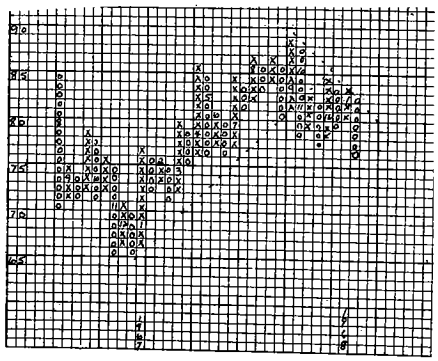
in individual issues. There is no question about it, the H & S tops are there aplenty. In fact, some of these tops are so classic that I have included charts (courtesy of Quote Digest again) above. The little collection pictured here is simply a fractional testament to the technical weakness and massive distribution which has shown itself in this market. The charts shown here could be used as textbook examples of the classic head-and-shoulder distributive top. The Baush & Lomb and the Penn. R. R. charts are so perfect and so symmetrical that I suggest they be placed in the archives of technical market literature. So much for that.

I include below (courtesy of Chartcraft, Larchmont, N.Y.) point and figure charts of what I term the two market "big guns," DuPont and General Motors. When these two stocks turn bearish, it has, throughout market history, been a negative indication for the entire market (remember, one out of every seven workers in the country works at something connected with automobiles, and DuPont is so huge that it literally has a finger in every industry in the nation).

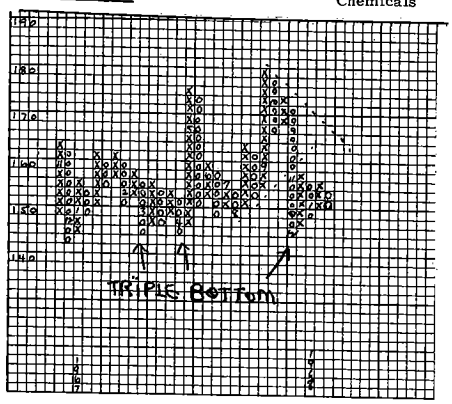
GM has formed a head-and-shoulders top so massive that it can only be appreciated in condensed point and figure form. GM gave its first bearish signal when it touched 79 early in the year. It gave a second more incisive sell signal when it shattered the entire formation at a recent 77.

DuPont turned bearish at 164 in late 1967, and it has been bearish ever since. A second bearish signal would come at 146. At 144 DD would rupture the huge triple bottom (arrows), in which case, the stock would in my mind signal a general blue chip collapse.

GENERAL MOTORS (GM) Auto



DU PONT (DD) Chemicals



All in all, although the market has come down very sharply from its recent September high of 908.92 on the Dow, an awful lot of stocks appear to be in the earlier stages of their downward descent. Indeed, such issues at Penn. R.R., Reichold, Nat. Steel, Ampex, Pittston (see charts) have either not broken their support yet or have just plunged through the support. They would appear to have a good deal further to go, so my advice continues to be patience while ignoring the short term.

LATE NOTES: As this is written (Feb. 15) the market is in its second day of rally from the February 13 low. The last decline in the Dow was an almost straight-line drop from 908 to 831. It would not be surprising to see the Industrials correct one-third to one half of this decline, which means a potential recovery to the 855-870 area.

During the past 22 trading days Dome, Campbell Red Lake and Homestake gained a combined total of 43 points, almost without a correction. Therefore, it would be perfectly normal to see the golds go into a rather important correction here, although of course nothing can be guaranteed. I do not believe that this is the end of the gold rise nor do I believe that this is the end of the market decline. Both movements are now secondary in nature — against the primary trend, which is bullish in golds, bearish for the market.